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The President’s Working Group on Financial Markets Issues Fundamental Principles relating to Private Pools of Capital

By Edward Grenville

The President’s Working Group on Financial Markets,¹ which last made a statement on hedge funds in 1999, issued a set of principles and guidelines on February 22, 2007. The principles are designed to provide guidance to U.S. regulators as they address issues associated with the rapid growth of private pools of capital, which includes private equity funds and hedge funds. Secretary Paulson stated that “[t]hese guidelines should serve as a foundation to enhance vigilance and market discipline further, which will strengthen investor protection and guard against systemic risk.” Barney Frank (4th Congressional District of Massachusetts), Chairman of the House Committee on Financial Services, issued a press release stating that the principles represent “a first step in addressing questions presented by the significant growth of hedge funds” and that he hopes that the “Presidential Working Group will be able to testify at a hearing on hedge funds as part of a series of hearings the Financial Services Committee will hold this spring.”

The principles, briefly summarized below, include a number of themes that have guided, and are likely to continue to guide, ongoing discussions concerning regulation of investment pools (and particularly hedge funds): investor access to material information from pools; direct investment in pools by sophisticated investors only; exercise of market discipline by parties dealing with pools (e.g. creditors); and appropriate internal controls by the pools themselves.

Public policies that support market discipline, participant awareness of risk, and prudent risk management, are the best means of protecting against systemic risk –

¹ The President’s Working Group on Financial Markets (“PWG”), chaired by Treasury Secretary Henry M. Paulson and composed of the chairmen of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, was formed in 1988 to further integrity, efficiency, orderliness, and competitiveness of
the risk that losses from one or more investment pools could threaten the stability of the broader financial system.

1. Investor protection can be addressed through a combination of market discipline and regulatory policies.

2. The risks of investing in private investment pools are most appropriately borne by sophisticated investors.

3. Investors should obtain accurate, timely, material information to be able to make an informed investment decision.

4. Sound practices of fiduciaries can address concerns of less sophisticated investors indirectly participating in private investment pools through pension and other funds.

5. Market discipline by creditors, counterparties and investors is the most effective mechanism for limiting systemic risk from private pools of capital.

6. Key creditors and counterparties must conduct appropriate due diligence and maintain appropriate risk management practices, and obtain quantitative and qualitative indicators of a private pool’s net asset value, performance, risk exposure, and liquidity.

7. Investors should ensure that the investment pool’s risk profile is compatible with their risk appetite.

8. Managers of private investment pools should have information, valuation, and risk management systems that meet sound industry practices.

9. Supervisors should communicate their expectations regarding prudent management of counterparty credit exposures.

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